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ABSTRACT

Pursuant to Chapter 156, the Legislative Analyst's Office has developed options for the California Legislature to implement a sliding-scale cost-of-living-adjustment (COLA) as a means of equalizing general purpose funding for school districts. Chapter 156 declares the Legislature's intent to replace the existing "uniform" COLA approach with a sliding-scale COLA as an ongoing mechanism to equalize revenue limits. This report summarizes the history of school finance to establish a context for understanding equalization. It assesses how Chapter 156 affects school district revenue limits and the implications for future revenue-limit equalization. The report discusses what constitutes adequate equalization and describes options for setting equalization goals. Three different sliding-scale COLA options are described, and recommendations are made to the Legislature. Although sliding-scale COLAs provide for faster equalization than the current uniform revenue-limit COLA, they will still take considerable time. If the Legislature wants to achieve its equalization goals more rapidly, this would require supplemental funding for equalization. These ongoing supplemental funds could be provided periodically or on an annual basis, depending on the Legislature's objectives and competing funding priorities. (DFR)

An LAO Report



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Introduction

LAO Findings

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Equalizing School District Funding: Option for a Sliding Scale COLA

Pursuant to Chapter 156, Statutes of 1998 (AB 2640, Leach and Runner) the Legislative Analyst's Office has developed options for the Legislature to implement a sliding-scale cost-of-living-adjustment (COLA) as a means of equalizing general purpose funding for school districts. Chapter 156 declares the Legislature's intent to replace the existing "uniform" COLA approach with a sliding-scale COLA.

The State Currently Meets Legal Requirements for Equalization. In the 1971 state Supreme Court decision, *Serrano v. Priest*, the court specified a range (currently around \$335 on either side of the statewide average revenue limit per pupil) to measure equality in school funding. Currently around 98 percent of the state's pupils are funded within this range, which meets the court's standards.

What Constitutes Equalization? Although the state has achieved a permissible legal level of equalization, from a policy perspective the Legislature has indicated its desire to further reduce revenue limit disparities. The Legislature, however, needs to explicitly establish its target for equalization.

Sliding-Scale COLA Would Better Equalize Revenue Limits. A sliding-scale approach would decrease differences in revenue limits more rapidly than the current approach. It does so by varying the amount of COLA provided based on the relationship of a district revenue limit to the equalization target. The farther below the target, the greater the COLA; the farther above the target, the smaller the COLA.

Relying Exclusively on the Sliding-Scale COLA to Close Equalization Gaps Still Would Take Considerable Time. Although the sliding-scale approach provides more rapid equalization progress, we estimate that reaching an equalization target would still require considerable time. For instance, it would take roughly from 12 to 45 years to bring at least 95 percent of pupils to the same revenue limit. For that reason, supplemental funds would be required to achieve a given equalization target in a short period of time.



INTRODUCTION

Chapter 156, Statutes of 1998 (AB 2460, Leach and Runner) requires the Legislative Analyst's Office to examine school district revenue limits for the 1998-99 fiscal year and to develop options regarding a sliding-scale cost-of-living adjustment (COLA) as an ongoing mechanism to equalize revenue limits. In this report, prepared pursuant to this legislation, we:

- ◆ Provide a brief history of school finance to establish a context for understanding equalization.
- ◆ Assess how Chapter 855, Statutes of 1997 (SB 727, Rosenthal), affects school district revenue limits and the implications for future revenue limit equalization.
- ◆ Discuss what constitutes adequate equalization and describe options for setting equalization goals.
- ◆ Describe three different sliding-scale COLA options.
- ◆ Make recommendations to the Legislature.

BACKGROUND

Funding California's 1,000 school districts is largely a state responsibility. The state determines the amount of total funding that school districts receive from state funds and local property taxes and the distribution formulas for these funds. The state is also responsible for ensuring relative equality in school district funding.

Since the early 1970s the state has implemented several strategies to "equalize" school district funding. In our *Analysis of the 1997-98 Budget Bill* (page E-61), we recommended that the Legislature reintroduce a sliding-scale COLA—modeled after Chapter 894, Statutes of 1977 (AB 65, Greene)—to replace the state's current uniform COLA formula as a more efficient means of equalizing revenue limits.

Revenue Limits and *Serrano v. Priest*.

Around two-thirds of state and local aid for public schools comes in the form of general purpose support, commonly referred to as revenue limit funding. Revenue limits were introduced by Chapter 1406, Statutes of 1972 (SB 90, Dills), as part of the state's response to the *Serrano v. Priest* state Supreme Court decision of 1971. This decision held that the state system of financing public schools was unconstitutional because it made resources available for education—and by extension, the quality of education—a function of the local property wealth of a school district. The court specified that wealth-related differences in school funding must be reduced to within a "band" of equality extending \$100 per pupil above and below the state average per pupil

spending. Adjusting for inflation, this permissible *Serrano* band currently is approximately \$335 on either side of the statewide average revenue limit per pupil (in terms of units of average daily attendance [ADA]).

In 1997-98 state and local general purpose support for school districts averaged \$3,785 per ADA. Around 98 percent of the state's students were funded within the *Serrano* band.

Since the 1971 *Serrano* decision, the Legislature periodically enacted legislation to equalize revenue limits among the state's school districts. Chapter 894, Statutes of 1977 (AB 65, Greene), established a school finance funding mechanism that provided school districts with different COLA amounts depending upon their per-pupil revenue limits. Under this mechanism, a district with a revenue limit above the statewide average received a smaller percentage COLA than a district with a revenue limit below the statewide average. Under this system, which operated only for a short period of time, per-pupil funding levels were drawn toward the statewide average (that is "squeezed"). Thus, funding disparities stemming from differences in district wealth were slightly reduced.

Current revenue limit COLA and equalization policy is based on Chapter 498, Statutes of 1983 (SB 813, Hart). Senate Bill 813 eliminated the squeeze formula, and instead provided that all districts of the same type (elementary, high school, and unified) receive the same fixed dollar amount per ADA as a COLA. In 1997-98 for

example, all elementary school districts received a COLA of \$98 per ADA, high school districts received \$117 per ADA, and unified districts received \$102 per ADA. This approach does nothing to reduce the dollar differentials between districts and only slightly reduces the percentage differentials. (Chapter 156 states the Legislature's intent to return to a sliding-scale COLA distribution for revenue limits similar to the one that was in effect between 1977 and 1983. Later in this report we describe some options for doing this.)

In addition to the "uniform" COLA of SB 813, the Legislature periodically has provided supplemental funds through a level-up approach for revenue limit equalization. Under this approach, funds have been provided to increase the revenue limits of below-average districts toward the state average. In calculating equalization adjustments, districts were divided into six categories based on type (elementary, high school, and unified districts, with each of these divided into small and large districts). The amount of equalization aid a district qualified for depended on the amount needed to bring its revenue limit to the average revenue limit in its category.

Senate Bill 727's Impact on Revenue Limits.

Attendance accounting for revenue limit funding purposes changed significantly following the passage of SB 727. Senate Bill 727 eliminated funding for "excused absences" from the revenue limit calculation beginning with the 1998-99 school year. Previously, schools were permitted to claim funding for excused absences, involving



absent students who were sick or not attending school for other specified reasons. By excluding excused absences from the revenue limit process, general purpose funding is now based on "actual attendance."

Because SB 727 affected 1998-99 revenue limits in significant ways, we reviewed the State Department of Education's (SDE) recalculated revenue limits before preparing this report. Senate Bill 727 had several important effects:

- ◆ It increased the *per ADA* revenue limit of every district, but by differing amounts. (The revenue limits were increased to offset the effect of lower attendance and keep total district revenues at the same level.)
- ◆ It also increased, to some extent, variation in revenue limits.
- ◆ Finally it changed who was above and who was below revenue limit averages.

Specifically, about 20 percent of school districts changed position relative to the average. Roughly half of these districts changed from below-average to above-average. The other half of these districts went from above-average to below-average. These changes do not appear to be explained by differences in school district wealth, size, or type (elementary, high school, or unified).

Although the SB 727 revenue limit changes have implications for how future rounds of revenue limit equalization might be distributed among some districts, the fundamental problem the Legislature has tried to address in past rounds of equalization remains the same—disparity in revenue limits among school districts. (For a complete listing of the recalculated school district limits, organized by legislative districts, please visit our web site at www.lao.ca.gov.)

WHAT CONSTITUTES ADEQUATE EQUALIZATION?

In preparing this report, it became evident that a basic policy question the Legislature needs to address is: What constitutes adequate equalization? From the standpoint of the *Serrano* court decision, the state already has achieved a permissible level of equalization. From a policy perspective, the Legislature clearly has indicated its desire to reduce revenue limit disparities further. The

Legislature, however, has not definitively stated how much equalization is enough.

The simplest answer to the question is that revenue limits are equalized when *all* districts' revenue limits are *exactly equal*. Achieving this degree of equalization, however, is prohibitively expensive (an estimated \$11 billion annually). This high cost is driven by the fact that a relative

handful of districts, for historical reasons, have extremely high revenue limits. For example, the highest authorized revenue limit for a large elementary district (\$5,556 per ADA) exceeds the statewide average for such districts by \$1,611. However, all but 2 percent of the state's large elementary district ADA receives a revenue limit within \$357 of the statewide average. These numbers indicate that equalization costs rise exponentially as equalization targets approach the highest possible revenue limits, and underscore why the Legislature should carefully address what constitutes "adequate" equalization.

For the six types of school districts, Figure 1 shows the current statewide average revenue limit, and the revenue limit amounts corresponding to four potential revenue limit targets. It also shows the annual costs of reaching these alternative targets. As the figure shows, the annual amount of additional spending that would be required to bring all districts to the currently authorized highest revenue limits is approximately \$11 billion. We believe this is an impractical target for the state for two reasons: (1) the cost is prohibitive; and (2) the resulting level of revenue limits would be based on historical anomalies, not on consideration of what districts need in the

form of general purpose funding to provide a quality education.

The other targets displayed in Figure 1 would substantially reduce existing revenue limit disparities at costs that are in the realm of practical consideration. These estimated costs range from \$175 million to equalize 90 percent of ADA to \$2.3 billion to equalize 98 percent of ADA. For example, the Legislature could decide that having 90 percent of the state's ADA receiving equal revenue limits—and having 10 percent of ADA receiving higher limits—is an acceptable policy outcome. If the Legislature made such a decision, it could reach this goal with a single augmentation of annual funding (\$175 million) or it could reach this goal over a period of several years by relying on the equalizing effects of a sliding-scale COLA. (We discuss some sliding-scale COLA options later in this report.)

Figure 1

Equalization Targets: Revenue Limit Funding Levels Per ADA

	Statewide Average	Percent of ADA Equalized			
		90%	95%	98%	100%
Small elementary	\$4,857	\$5,063	\$5,451	\$6,792	\$7,729
Small high school	5,263	5,360	5,370	5,377	5,378
Small unified	4,395	4,541	4,700	4,980	5,741
Large elementary	\$3,945	\$4,000	\$4,100	\$4,302	\$5,556
Large high school	4,698	4,792	4,858	4,880	5,678
Large unified	4,088	4,134	4,249	4,549	6,141
Cost to Equalize	\$150 million	\$175 million	\$960 million	\$2.3 billion	\$11 billion

^a These amounts represent undedicated 1998-99 revenue limits.



Other Considerations: Cost Relationships by District Type. Additional considerations become apparent from the data in Figure 1. For example, the current statewide averages reflect historical cost relationships among the six types of districts. Average revenue limits for small districts are higher than the average for large districts of the same type (elementary, high school, unified), reflecting the economies of scale enjoyed by the large districts. Average limits of high school districts are higher than the average of corresponding elementary districts, reflecting the higher-cost requirements of providing a high school curriculum. These cost relationships would be distorted if the

Legislature used the equalization targets in Figure 1, without making some modifications. For example, at the 95 percentile and above, small elementary districts would receive higher revenue limits than small high school districts, reversing the historical cost relationship. This and other examples raise subsidiary questions that the Legislature should address in fashioning its equalization policy. To what extent does the Legislature want to preserve the current relative cost structure by district type? Are there other cost considerations that merit creation of new district types for revenue limit purposes, such as high-cost versus low-cost geographic areas?

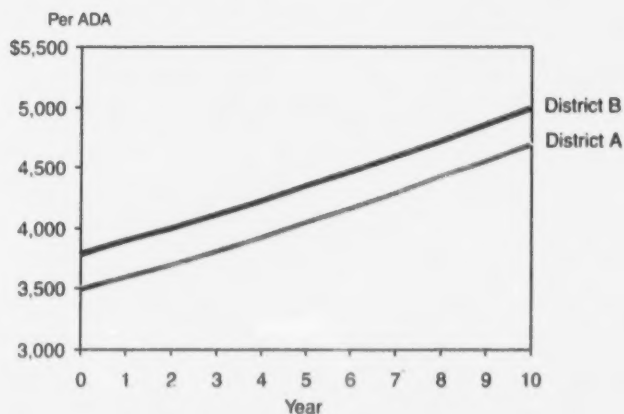
ADVANTAGE OF SLIDING-SCALE COLA

Our 1997-98 Analysis highlighted problems with the state's current approach to using revenue limit COLA funds for equalization purposes. In that analysis, we recommended that the Legislature return to a sliding-scale COLA to more effectively achieve equalization. We briefly review our findings below.

Current COLA Does Little for Equalization. The current uniform COLA sometimes is described as a "percentage equalizing" COLA. Figure 2

Figure 2

**Current COLA Distribution Formula:
Effect on District Revenue Limits**



illustrates the operation of this COLA over time using two hypothetical districts—A and B.

Figure 2 shows that the dollar difference between the two districts does not change over time. The dollar difference was \$300 in year one and remains at \$300 in year ten. Because the total revenue limit increases over time, the percentage difference between the two gets smaller over time. In year one, District B's \$300 advantage is 9 percent higher than District A's (\$3,800 compared to \$3,500). By year ten, the \$300 advantage is only 6 percent higher than District A's (\$5,004 compared to \$4,704).

Sliding-Scale COLA Would Better Equalize Revenue Limits. We recommended in the 1997-98 Analysis that the Legislature replace the existing

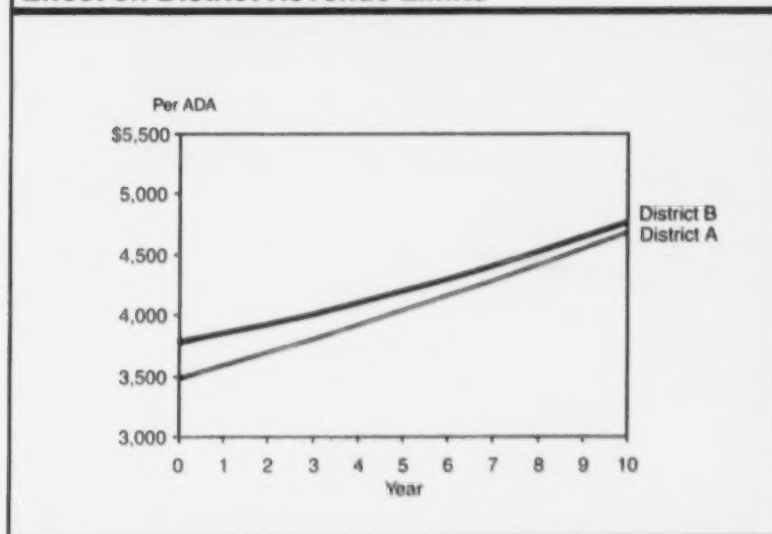
uniform COLA with a sliding-scale COLA, and Chapter 156 states the Legislature's intent to do this. Under the sliding-scale approach the COLA varies based on the relationship of districts' revenue limits to the statewide average. The farther below the average, the greater the COLA; the farther above the average, the smaller the COLA. In effect, the "savings" from granting smaller COLAs to above-average districts are used to supplement the COLAs of below-average districts. The approach is similar to the AB 65 COLA, which was in effect from 1977 to 1983. As Figure 3 shows, the sliding-scale approach results in the dollar difference between the two hypothetical districts decreasing over time.

This type of adjustment can be constructed to guarantee a COLA to every school district. The

important point, however, is that no matter what parameters are chosen, a sliding-scale COLA can reach a point at which revenue limits are equal faster than the current COLA mechanism used by the state. The downside, however, is that districts with revenue limits well above the equalization target would experience some decrease in their overall spending power because their revenue limits would not grow as fast as inflation. This can be mitigated by setting a floor to the scale.

Figure 3

**Sliding-Scale COLA Distribution:
Effect on District Revenue Limits**





SLIDING-SCALE COLA OPTIONS

Equalization requires a combination of time, resources, and commitment. In this section we illustrate how a sliding-scale COLA mechanism can be used for equalization using three alternative sliding-scale formulas. For the sake of illustration, we use a policy target of equalizing 95 percent of ADA.

Figure 4 illustrates three sliding-scale options. They differ in the "steepness" of scale. This steepness of scale determines how much COLA low-revenue districts receive, as well as how much COLA the highest revenue limit districts receive. It also determines how quickly COLA funds can advance the state toward specified equalization goals. Generally, a "steeper" scale results in faster equalization, but also results in the highest-revenue districts receiving correspondingly smaller COLAs.

For example, in the figure, the "least steep" scale is "set" to gradually reduce the COLA for districts above the target. At 200 percent of the equalization target, the COLA has phased down to zero. Under this scale, even the highest revenue limits would receive a partial COLA because there are no districts with revenue limits more than 200 percent of the target amount. This means, however, that there are less COLA "savings" to redistribute to the low-revenue districts. As a result, a less-steep scale requires longer to equalize.

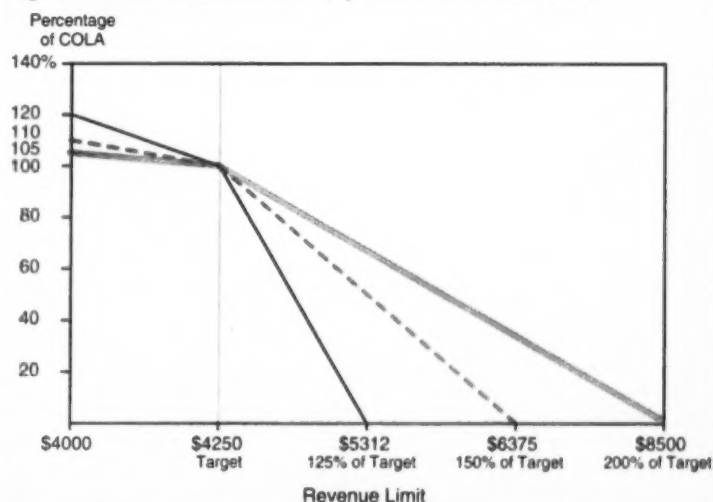
The options presented in the figures are based, for the sake of illustration, on equalizing 95 percent of ADA. These options, of course, could be used with alternative equalization targets. Generally, the higher the target, the more time would be needed for a sliding-scale COLA of a given steepness to provide the specified equalization.

For example, we estimate that the steepest scale shown would permit the state to reach the 95 percent equalization target in roughly 12 years. (This assumes an annual inflation rate of 3 percent and that COLA funds are the sole equalizing mechanism.) The moderately steep scale would take roughly 20 years and the least steep scale would take roughly 45 years. These examples show that, despite the fact that sliding-scale

Figure 4

Sliding-Scale COLA Distribution—Three Options

Large Unified School Districts Equalized to 95% of ADA



COLAs provide more rapid equalization than the current uniform COLA, it still takes considerable time to equalize if the Legislature relies exclusively on the distribution of COLA monies as its equal-

ization tool. For that reason, supplemental funds would be required to achieve a given equalization target in a short period of time.

LAO RECOMMENDATIONS

Based on our review of 1998-99 revenue limits, we recommend that the Legislature enact legislation to replace the current uniform revenue limit COLA with a sliding-scale COLA that would provide an ongoing form of equalization for revenue limits. For purposes of this legislation, we recommend that the Legislature specify a practical equalization goal—that is, specify a point at which disparities in revenue limits can be reduced to acceptable levels. This will be a policy choice for the Legislature that is somewhat subjective. A practical equalization goal would involve equalizing revenue limits for at least 90 percent of ADA (implicitly allowing no more than 10 percent of ADA to be funded above the equalized amount). In setting equalization targets, the Legislature should consider what adjustments, if any, may be needed to assure that revenue limit relationships among the different types of districts retain a rational tie to the different per pupil costs of providing educational services.

In establishing a sliding-scale COLA, the Legislature also needs to decide how “steep” the scale will be. This will determine how much COLA the highest revenue limit districts would receive as

well as how much COLA low-revenue districts would receive. It will also determine how quickly COLA funds can advance the state toward the specified equalization goals. Generally, a steeper scale results in faster equalization, but also results in the highest-revenue districts receiving correspondingly smaller COLAs.

Although sliding-scale COLAs provide for faster equalization than the current uniform revenue limit COLA, they will still take considerable time, as illustrated by the examples noted above. If the Legislature wants to achieve its equalization goals more rapidly, this would require supplemental funding for equalization. (As discussed in this paper's background section, the Legislature has periodically provided supplemental funds for equalization.) Ongoing supplemental funds could be provided periodically or on an annual basis, depending on the Legislature's objectives and competing funding priorities. The funds could be concentrated on the lowest-revenue districts first, or could be spread across all districts that are below the equalization targets. However distributed, supplemental funds could rapidly hasten attainment of the Legislature's equalization goals.



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